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The New York Times

INTERNATIONAL BUSINESS

Porsche reinvents the short squeeze

OCT. 30, 2008

NEW YORK — On Wall Street, a corner is not just an intersection of two streets. It is also a way to extract huge profits from speculators who had the temerity to sell a stock short.

Now the question is whether Porsche has pulled off a brilliant new-fashioned corner in Volkswagen stock, using derivatives in clever ways that no one had thought of before, or whether it was too clever for its own good.

In a corner, a buyer or group of buyers purchases a lot of stock. As the price goes up, short-sellers appear. They borrow stock - perhaps from the very same group - and sell it, hoping to make a profit when the price declines.

Then comes the squeeze. The group, which now owns more shares than exist, demands the return of the borrowed stock. The only way the short-sellers can comply with that request is to purchase shares, and the only one who has shares to sell is the corner group. The group can set its own price and make a fortune.

One reason you don't see many corners these days is that they are illegal in most countries. But another is that almost everybody involved tends to lose in the end, with the exception of lucky investors who happened to own the stock before the fun started and can sell into the big run-up in prices.

Those who execute corners usually make lots of money from the short-sellers. But they end up owning a company for which they paid too much. The stock is

delisted from the stock exchange, since, without enough public shareholders, there is no ready market for the stock. If the group that executed the corner used borrowed money, it may be in big trouble.

In the 1920s, the most famous corner in the United States was in stock in Piggly Wiggly, a grocery store chain. The corner was successful, but the man who executed it eventually went broke.

But there have been successful corners. Cornelius Vanderbilt once pulled one off, with members of the New York City Council as the victims. They had tried to profit by shorting a railroad company that Vanderbilt controlled, and then revoking the company's principal asset: a license to operate a street railway. Vanderbilt bought shares and kept the price from falling. Owning more shares than there were outstanding, he offered to let the council members cover their short positions with only small losses if they reinstated the license. They did.

The big loser in that corner was a legendary speculator, Daniel Drew, who had proposed the idea to the council members. He was forced to purchase shares at very high prices.

It is Drew who is credited with the saying, "He who sells what isn't his'n, must buy it back or go to pris'n."

For the cornerer, there is also the risk that rules will change when powerful people get in trouble. That was one of the things that broke the Hunt brothers' attempted corner in silver in 1980. The authorities made it almost impossible to bet on rising silver prices, and the Hunts went broke.

Now, from Germany we have a new version of the corner, using derivatives in a way that may have removed much of the risk for the people planning the corner.

Briefly, here are the relevant facts. Porsche, for some reason, wants to control Volkswagen, and by building up its stake has driven up the price. Hedge funds, figuring the share price would fall as soon as Porsche got control and stopped buying, sold a lot of VW shares short.

Then last weekend, Porsche disclosed that it owned 42.6 percent of the stock and had acquired options for another 31.5 percent. It said it wanted to go to 75 percent.

The result: instant short-squeeze. The German state of Lower Saxony owns a 20 percent stake in VW, which it said it would not sell. That left precious few shares available for anyone else. The shorts scrambled to cover, and the price leaped from about €200, or about $265, to above €1,000. VW became the world's most valuable company, if you believed that market price.

It appears that Porsche put one over on whoever wrote that option, or options. The options are said to be cash-settled, although we do not know much more about them than that. That means Porsche does not have to buy the shares - which it might have a lot of trouble paying for.

Instead, it merely has to accept the cash difference between the market price and the price it has agreed to pay. The result could be tens of billions of euros in profits without the headache of owning shares that no one else wants to buy.

There has been a lot of speculation about who is on the hook for those options. Of course, those people may have used other derivatives to lay some of their risk off on who-knows-who-else. That is one result of having opaque markets, which Wall Street used to love because it made for higher profit margins. Now it may be one more loss for some already reeling bank or banks.

After all this is done, the VW share price will fall to a more reasonable level. And there are rumors that Porsche has purchased put options, presumably with later exercise dates, to profit from that fall.

By Tuesday night, the establishment was fighting back. Germany's premier stock index, the DAX, was changed to cut VW's proportion in it. That allowed index funds to sell stock, adding to the supply of shares, and VW's shares lost part of their gains.

In the United States, there are numerous laws and regulations to stop corners. But Porsche insists that it broke no German laws, adding that "allegations of price

manipulation by Porsche are therefore without any foundation whatsoever." It placed the blame on - you guessed it - "speculative short-sellers."

If this works, Porsche will have made billions from a car company at a time when cars are not selling very well. It won't have done that by selling cars, but a profit is a profit.

Of course, rules can be changed, as Nelson Bunker and William Herbert Hunt learned. The brothers angrily protested that it was unfair to change the rules in the middle of the game, but the rules were changed and the brothers went from billionaires to bankrupts.

If it comes to a question of whether regulators step in, Porsche has the advantage of facing off against short-selling hedge funds. There may not be a less popular group of investors, and their losses will provoke little sympathy.

But banks now have friends in high places. If Porsche's option coup threatens a major bank, the bank might ask for help. Will governments step in to protect their investments? Stay tuned.

A version of this article appears in print on October 30, 2008, in The International Herald Tribune.